In the Supreme Court of the United States

OCTOBER TERM, 1963

No. 635

WILLIAM K. CARPENTER and FRANCIS K. CARPENTER, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

In January 1954, the petitioner purchased for $500,000 a single-premium annuity contract from the Old Republic Life Insurance Company. The cash surrender or loan value of the policy was $492,000 and would increase at approximately 3% a year. Upon acquiring the policy, the petitioner immediately "borrowed" from the Company its full cash value, $492,000. The loan bore interest at 4% per year and was secured solely by the policy, the petitioner having no personal liability for its repayment. The proceeds of the loan were used to repay a one-day bank loan by which the purchase of the policy had been financed.

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Also in 1954, the petitioner prepaid eight years' "interest" on the loan in the amount of $189,834. As a result of the interest prepayment, the cash surrender value of the policy increased by $113,000 (*i.e.*, to the value it would have had at the end of eight years). Upon payment of the interest, the petitioner again immediately "borrowed" back the full increase in the cash surrender value, $113,000. The net result of the year's transactions was that petitioner was out of pocket $84,834 (having paid the Company $689,834 and received back $605,000) and owned an annuity contract with a net value of zero.

In his income tax return for 1954, petitioner claimed a deduction for interest paid in the amount of $189,834. The Commissioner disallowed the deduction and as a result determined a deficiency of $168,952. The Tax Court upheld the deficiency, and the court of appeals affirmed.

1. This case is indistinguishable from and is fully controlled by *Knetsch* v. *United States*, 364 U.S. 361. Here, as there, the transaction resulted in the creation merely of offsetting paper promises and was wholly lacking in commercial substance. In effect, the Company promised to pay petitioner $492,000 plus accretions at the rate of 3% in exchange for petitioner's promise to pay the Company $492,000 plus interest at the rate of 4%. With the amount of the loans and the value of the policy being kept equal, the purported "obligations" could at any time be canceled out against each other, with neither party having any further liabilities. For its role in creating the facade, the Company retained $8,000 of the initial payment

and the 1% differential in the "interest" rates. For petitioner, however, the transaction was economically self-defeating: "there was nothing of substance to be realized * * * from this transaction beyond a tax deduction" (*Knetsch, supra*, at 366). As the Court held of the substantially identical transaction in *Knetsch*, a transaction so lacking in commercial substance is a "sham" for federal tax purposes and does not create an "indebtedness" the "interest" on which is deductible under § 163(a) of the Code. And since, under *Knetsch*, it is "what was done" and not motivation as such that is controlling (*id.* at 365, n. 2), petitioner's contention (Pet. 10–16) that he had valid non-tax reasons for entering the transaction would be irrelevant even if it were plausible.[1]

The decision below is also fully in accord with the lower court decisions. With the single exception of the conflicting decision which provided the occasion

[1] Petitioner asserts that he had decided to invest an expected inheritance in such a policy but did not wish to postpone the purchase until he received the inheritance because the policy would cost more if purchased later (Pet. 6, 11, 13–14). With the cash surrender value of such a policy increasing at a rate of 3% a year, it is of course not surprising that the initial cost of purchasing an equivalent policy would increase from year to year at about the same rate (compare petitioner's examples of what the premium would have been had the purchase been postponed (Pet. 14, n. 4) with the table of cash surrender values in the policy (R. 173a)). What petitioner does not explain, however, is the non-tax reason for paying 4% interest to obtain the benefit of the 3% rate of increase in the value of the policy. The necessary result of adding the interest payments to the initial premium is that the total cost to petitioner was *greater*, not less, than if the purchase of the policy had been delayed.

for the grant of certiorari in the *Knetsch* case (*United States* v. *Bond*, 258 F. 2d 577 (C.A. 5)), the lower courts have uniformly denied effect, for purposes of generating an interest deduction, to the type of transaction involved here. See, *e.g.*, *Weller* v. *Commissioner* 270 F. 2d 294 (C.A. 3), certiorari denied, 364 U.S. 908; *Diggs* v. *Commissioner*, 281 F. 2d 326 (C.A. 2), certiorari denied, 364 U.S. 908; *Pierce* v. *Commissioner*, 311 F. 2d 894 (C.A. 9), certiorari denied, 373 U.S. 912; *Salley* v. *Commissioner*, 319 F. 2d 847 (C.A. 5).

2. Since the decision below is fully supportable on the authority of the *Knetsch* case and of the court of appeals' own prior decision in the *Weller* case, *supra*—the primary basis for the decision—petitioner's argument (Pet. 17–23) addressed to a further and unnecessary observation made in the court's opinion and later modified [2] is beside the point and affords no basis for review of the decision by this Court.

3. Petitioner's reliance on private ruling letters addressed to other taxpayers (Pet. 27–33) is unavailing, for it is settled that such rulings, addressed to individual taxpayers, have no binding effect as to other

[2] At one point in its opinion, the court commented that policy loans are, in substance, advance payments of policy proceeds (Pet. 37–38). Because that statement appeared to constitute possible prejudgment of another case which had been argued before the Third Circuit *en banc* but had not yet been decided (*United States* v. *Wilson, et al.*, Nos. 13858, 13859, 13957, 14091 and 14092), the Commissioner moved for a modification of the opinion. Objection was made to the court's opinion only insofar as it purported to go beyond the facts of this case (see Pet. 17–18). On October 11, 1963, the court amended its opinion to limit its characterization to the circumstances of this case (Pet. 40–41).

taxpayers,[3] regardless of whether they have actually relied upon them.[4] And any suggestion that the private rulings, even if not binding in themselves, reflected a consistent administrative practice which should control the interpretation of the statute (see Pet. 29–30) is foreclosed by this Court's contrary interpretation of the statute in *Knetsch*.

The petition for certiorari should be denied.

Respectfully submitted.

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[3] *E.g., Automobile Club* v. *Commissioner*, 353 U.S. 180; *Commissioner* v. *P. G. Lake, Inc.*, 356 U.S. 260, 265–266, n. 5; *Helvering* v. *New York Trust Co.*, 292 U.S. 455, 467–468; see Treasury Regulations on Procedural Rules (1954 Code), § 601.201(l) (4), (5), and (7); cf. 1954 Code § 7805(b).

[4] *Gerstell* v. *Commissioner*, 319 F. 2d 131 (C.A. 3), certiorari denied, December 9, 1963 (No. 482); *Weller* v. *Commissioner*, 270 F. 2d 294 (C.A. 3), certiorari denied, 364 U.S. 908; *Goodstein* v. *Commissioner*, 267 F. 2d 127 (C.A. 1).

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